

## Senate Bill No. 754

### CHAPTER 100

An act to amend Sections 16328, 16335, 16336, and 16338, and to add Sections 16336.4, 16336.5, 16336.6, and 16336.7 to, the Probate Code, relating to trusts.

[Approved by Governor July 21, 2005. Filed with  
Secretary of State July 21, 2005.]

#### LEGISLATIVE COUNSEL'S DIGEST

SB 754, Poochigian. Unitrust conversions.

Existing law governs proceedings for the administration of trusts.

This bill would authorize a trustee, unless prohibited by the governing instrument, to convert a trust into a unitrust, pursuant to specified procedures. The bill would permit the trustee to convert a trust into a unitrust without a court order if specified conditions and requirements are satisfied, the trustee gives written notice of the intent to convert in accordance with certain notice requirements, and no beneficiary objects to the proposed action in writing during a specified timeframe. The bill would give the trustee the power, after a trust is converted to a unitrust, to make regular distributions of trust income in accordance with specified provisions. The bill would also establish procedures by which a trustee may reconvert from a unitrust to a trust and change the distribution payout percentage of a unitrust. The bill would require a fiduciary administering a unitrust, reconverting a unitrust, or changing the percentage payout from a unitrust to administer the trust impartially. The bill would make other conforming changes to related provisions of law related to trust administration.

*The people of the State of California do enact as follows:*

SECTION 1. Section 16328 of the Probate Code is amended to read:

16328. "Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the accounting period, plus or minus transfers under this chapter to or from income during the accounting period. During any period in which the trust is being administered as a unitrust, either pursuant to the powers conferred by Sections 16336.4 to 16336.6, inclusive, or pursuant to the terms of the governing instrument, "net income" means the unitrust amount, if the unitrust amount is no less than 3 percent and no more than 5 percent of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis.

SEC. 2. Section 16335 of the Probate Code is amended to read:

16335. (a) In allocating receipts and disbursements to or between principal and income, and with respect to any other matter within the scope of this chapter, a fiduciary:

(1) Shall administer a trust or decedent's estate in accordance with the trust or the will, even if there is a different provision in this chapter.

(2) May administer a trust or decedent's estate by the exercise of a discretionary power of administration given to the fiduciary by the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this chapter, and no inference that the fiduciary has improperly exercised the discretion arises from the fact that the fiduciary has made an allocation contrary to a provision of this chapter.

(3) Shall administer a trust or decedent's estate in accordance with this chapter if the trust or the will does not contain a different provision or does not give the fiduciary a discretionary power of administration.

(4) Shall add a receipt or charge a disbursement to principal to the extent that the trust or the will and this chapter do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) In exercising a discretionary power of administration regarding a matter within the scope of this chapter, whether granted by a trust, a will, or this chapter, including the trustee's power to adjust under subdivision (a) of Section 16336, and the trustee's power to convert into a unitrust or reconvert or change the unitrust payout percentage pursuant to Sections 16336.4 to 16336.6, inclusive, the fiduciary shall administer the trust or decedent's estate impartially, except to the extent that the trust or the will expresses an intention that the fiduciary shall or may favor one or more of the beneficiaries. The exercise of discretion in accordance with this chapter is presumed to be fair and reasonable to all beneficiaries.

SEC. 3. Section 16336 of the Probate Code is amended to read:

16336. (a) Subject to subdivision (b), a trustee may make an adjustment between principal and income to the extent the trustee considers necessary if all of the following conditions are satisfied:

(1) The trustee invests and manages trust assets under the prudent investor rule.

(2) The trust describes the amount that shall or may be distributed to a beneficiary by referring to the trust's income.

(3) The trustee determines, after applying the rules in subdivision (a) of Section 16335, and considering any power the trustee may have under the trust to invade principal or accumulate income, that the trustee is unable to comply with subdivision (b) of Section 16335.

(b) A trustee may not make an adjustment between principal and income in any of the following circumstances:

(1) Where it would diminish the income interest in a trust (A) that requires all of the income to be paid at least annually to a spouse and (B) for which, if the trustee did not have the power to make the adjustment, an estate tax or gift tax marital deduction would be allowed, in whole or in part.

(2) Where it would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion.

(3) Where it would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.

(4) Where it would be made from any amount that is permanently set aside for charitable purposes under a will or trust, unless both income and principal are so set aside.

(5) Where possessing or exercising the power to make an adjustment would cause an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment.

(6) Where possessing or exercising the power to make an adjustment would cause all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment.

(7) Where the trustee is a beneficiary of the trust.

(8) During any period in which the trust is being administered as a unitrust pursuant to the trustee's exercise of the power to convert provided in Section 16336.4 or 16336.5, or pursuant to the terms of the governing instrument.

(c) Notwithstanding Section 15620, if paragraph (5), (6), or (7) of subdivision (b) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the trust.

(d) A trustee may release the entire power conferred by subdivision (a) or may release only the power to adjust from income to principal or the power to adjust from principal to income in either of the following circumstances:

(1) If the trustee is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (1) to (6), inclusive, of subdivision (b).

(2) If the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subdivision (b).

(e) A release under subdivision (d) may be permanent or for a specified period, including a period measured by the life of an individual.

(f) A trust that limits the power of a trustee to make an adjustment between principal and income does not affect the application of this section unless it is clear from the trust that it is intended to deny the trustee the power of adjustment provided by subdivision (a).

(g) In deciding whether and to what extent to exercise the power to make adjustments under this section, the trustee may consider, but is not limited to, any of the following:

- (1) The nature, purpose, and expected duration of the trust.
  - (2) The intent of the settlor.
  - (3) The identity and circumstances of the beneficiaries.
  - (4) The needs for liquidity, regularity of income, and preservation and appreciation of capital.
  - (5) The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor.
  - (6) The net amount allocated to income under other statutes and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available.
  - (7) Whether and to what extent the trust gives the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.
  - (8) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.
  - (9) The anticipated tax consequences of an adjustment.
  - (h) Nothing in this section or in this chapter is intended to create or imply a duty to make an adjustment, and a trustee is not liable for not considering whether to make an adjustment or for choosing not to make an adjustment.
- SEC. 4. Section 16336.4 is added to the Probate Code, to read:
- 16336.4. (a) Unless expressly prohibited by the governing instrument, a trustee may convert a trust into a unitrust, as described in this section. A trust that limits the power of the trustee to make an adjustment between principal and income or modify the trust does not affect the application of this section unless it is clear from the governing instrument that it is intended to deny the trustee the power to convert into a unitrust.
- (b) The trustee may convert a trust into a unitrust without a court order if all of the following apply:
- (1) The conditions set forth in subdivision (a) of Section 16336 are satisfied.
  - (2) The unitrust proposed by the trustee conforms to the provisions of paragraphs (1) to (8), inclusive, of subdivision (e).
  - (3) The trustee gives written notice of the trustee's intention to convert the trust into a unitrust and furnishes the information required by subdivision (c). The notice shall comply with the requirements of Chapter 5 (commencing with Section 16500), including notice to a beneficiary who is a minor and to the minor's guardian, if any.
  - (4) No beneficiary objects to the proposed action in a writing delivered to the trustee within the period prescribed by subdivision (d) of Section 16502 or a longer period as is specified in the notice described in subdivision (c).

(c) The notice described in paragraph (3) of subdivision (b) shall include a copy of Sections 16336.4 to 16336.7, inclusive, and all of the following additional information:

(1) A statement that the trust shall be administered in accordance with the provisions of subdivision (e) and the effective date of the conversion.

(2) A description of the method to be used for determining the fair market value of trust assets.

(3) The amount actually distributed to the income beneficiary during the previous accounting year of the trust.

(4) The amount that would have been distributed to the income beneficiary during the previous accounting year of the trust had the trustee's proposed changes been in effect during that entire year.

(5) The discretionary decisions the trustee proposes to make as of the conversion date pursuant to subdivision (f).

(d) In deciding whether to exercise the power conferred by this section, a trustee may consider, among other things, the factors set forth in subdivision (g) of Section 16336.

(e) Except to the extent that the court orders otherwise or the parties agree otherwise pursuant to Section 16336.5 after a trust is converted to a unitrust, all of the following shall apply:

(1) The trustee shall make regular distributions in accordance with the governing instrument construed in accordance with the provisions of this section.

(2) The term "income" in the governing instrument shall mean an annual distribution, the unitrust amount, equal to 4 percent, which is the payout percentage, of the net fair market value of the trust's assets, whether those assets would be considered income or principal under other provisions of this chapter, averaged over the lesser of: (A) the three preceding years, or (B) the period during which the trust has been in existence.

(3) During each accounting year of the trust following its conversion into a unitrust, the trustee shall, as early in the year as is practicable, furnish each income beneficiary with a statement describing the computation of the unitrust amount for that accounting year.

(4) The trustee shall determine the net fair market value of each asset held in the trust no less often than annually. However, the following property shall not be included in determining the unitrust amount:

(A) Any residential property or any tangible personal property that, as of the first business day of the current accounting year, one or more current beneficiaries of the trust have or have had the right to occupy, or have or have had the right to possess or control, other than in his or her capacity as trustee of the trust, which property shall be administered according to other provisions of this chapter as though no conversion to a unitrust had occurred.

(B) Any asset specifically devised to a beneficiary to the extent necessary, in the trustee's reasonable judgment, to avoid a material risk of exhausting other trust assets prior to termination of the trust. All net

income generated by a specifically devised asset excluded from the unitrust computation pursuant to this subdivision shall be accumulated or distributed by the trustee according to the rules otherwise applicable to that net income pursuant to other provisions of this chapter.

(C) Any asset while held in a testator's estate or a terminating trust.

(5) The unitrust amount, as otherwise computed pursuant to this subdivision, shall be reduced proportionately for any material distribution made to accomplish a partial termination of the trust required by the governing instrument or made as a result of the exercise of a power of appointment or withdrawal, other than distributions of the unitrust amount, and shall be increased proportionately for the receipt of any material addition to the trust, other than a receipt that represents a return on investment, during the period considered in paragraph (2) in computing the unitrust amount. For the purpose of this paragraph, a distribution or an addition shall be "material" if the net value of the distribution or addition, when combined with all prior distributions made or additions received during the same accounting year, exceeds 10 percent of the value of the assets used to compute the unitrust amount as of the most recent prior valuation date. The trustee may, in the reasonable exercise of his or her discretion, adjust the unitrust amount pursuant to this subdivision even if the distributions or additions are not sufficient to meet the definition of materiality set forth in the preceding sentence.

(6) In the case of a short year in which a beneficiary's right to payments commences or ceases, the trustee shall prorate the unitrust amount on a daily basis.

(7) Unless otherwise provided by the governing instrument or determined by the trustee, the unitrust amount shall be considered paid in the following order from the following sources:

(A) From the net taxable income, determined as if the trust were other than a unitrust.

(B) From net realized short-term capital gains.

(C) From net realized long-term capital gains.

(D) From tax-exempt and other income.

(E) From principal of the trust.

(8) Expenses that would be deducted from income if the trust were not a unitrust may not be deducted from the unitrust amount.

(f) The trustee shall determine, in the trustee's discretion, all of the following matters relating to administration of a unitrust created pursuant to this section:

(1) The effective date of a conversion to a unitrust.

(2) The frequency of payments in satisfaction of the unitrust amount.

(3) Whether to value the trust's assets annually or more frequently.

(4) What valuation dates to use.

(5) How to value nonliquid assets.

(6) The characterization of the unitrust payout for income tax reporting purposes. However, the trustee's characterization shall be consistent.

(7) Any other matters that the trustee deems appropriate for the proper functioning of the unitrust.

(g) A conversion into a unitrust does not affect a provision in the governing instrument directing or authorizing the trustee to distribute principal or authorizing the exercise of a power of appointment over or withdrawal of all or a portion of the principal.

(h) A trustee may not convert a trust into a unitrust in any of the following circumstances:

(1) If payment of the unitrust amount would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.

(2) If the unitrust distribution would be made from any amount that is permanently set aside for charitable purposes under the governing instrument and for which a federal estate or gift tax deduction has been taken, unless both income and principal are set aside.

(3) If possessing or exercising the power to convert would cause an individual to be treated as the owner of all or part of the trust for federal income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to convert.

(4) If possessing or exercising the power to convert would cause all or part of the trust assets to be subject to federal estate or gift tax with respect to an individual, and the assets would not be subject to federal estate or gift tax with respect to the individual if the trustee did not possess the power to convert.

(5) If the conversion would result in the disallowance of a federal estate tax or gift tax marital deduction that would be allowed if the trustee did not have the power to convert.

(i) If paragraph (3) or (4) of subdivision (h) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may convert the trust unless the exercise of the power by the remaining trustee or trustees is prohibited by the governing instrument. If paragraph (3) or (4) of subdivision (h) applies to all of the trustees, the court may order the conversion as provided in subdivision (b) of Section 16336.5.

(j) A trustee may release the power conferred by this section to convert to a unitrust if (1) the trustee is uncertain about whether possessing or exercising the power will cause a result described in paragraph (3), (4), or (5) of subdivision (h), or (2) the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subdivision (h). The release may be permanent or for a specified period, including a period measured by the life of an individual.

SEC. 5. Section 16336.5 is added to the Probate Code, to read:

16336.5. (a) The trustee may convert a trust into a unitrust upon terms other than those set forth in subdivision (e) of Section 16336.4, without court order, if all of the following apply:

(1) The conditions set forth in subdivision (a) of Section 16336 are satisfied.

(2) The trustee gives written notice of the trustee's intention to convert the trust into a unitrust and furnishes the information required by subdivision (c) of Section 16336.4. The notice shall comply with the requirements of Chapter 5 (commencing with Section 16500), including notice to a beneficiary who is a minor and to the minor's guardian, if any.

(3) The payout percentage to be adopted is at least 3 percent and no greater than 5 percent.

(4) All beneficiaries entitled to notice under Section 16501 consent in writing to the proposed action after having been furnished with the notice described in subdivision (c) of Section 16336.4.

(b) The court may order the conversion of a trust into a unitrust as provided in this subdivision.

(1) (A) The trustee may petition the court to approve the conversion to a unitrust for any one of the following reasons:

(i) A beneficiary timely objects to a proposed conversion to a unitrust.

(ii) The trustee proposes to make the conversion upon terms other than those described in subdivision (e) of Section 16336.4.

(iii) Paragraph (3) or (4) of subdivision (h) of Section 16336.4 applies to all currently acting trustees.

(iv) If the trustee determines, in its discretion, that a petition is advisable.

(B) In no event, however, may the court authorize conversion to a unitrust with a payout percentage of less than 3 percent or greater than 5 percent of the fair market value of the trust assets.

(2) A beneficiary may petition the court to order the conversion.

(3) The court shall approve the conversion proposed by the trustee or direct the conversion requested by the beneficiary if the conditions set forth in subdivision (a) of Section 16336 are satisfied and the court concludes that conversion of the trust on the terms proposed will enable the trustee to better comply with the provisions of subdivision (b) of Section 16335.

(4) In deciding whether to approve a proposed conversion or direct a requested conversion, the court may consider, among other factors, those described in subdivision (g) of Section 16336.

SEC. 6. Section 16336.6 is added to the Probate Code, to read:

16336.6. Unless expressly prohibited by the governing instrument, a trustee may reconvert the trust from a unitrust or change the payout percentage of a unitrust.

(a) The trustee may make the reconversion or change in payout percentage without a court order if all of the following conditions are satisfied:

(1) At least three years have elapsed since the most recent conversion to a unitrust.



(2) The trustee determines that reconversion or change in payout percentage would enable the trustee to better comply with the provisions of subdivision (b) of Section 16335.

(3) One of the following notice requirements is satisfied:

(A) In the case of a proposed reconversion, the trustee gives written notice of the trustee's intention to convert that complies with the requirements of Chapter 5 (commencing with Section 16500) and no beneficiary objects to the proposed action in a writing delivered to the trustee within the period prescribed by subdivision (d) of Section 16502. The trustee's notice shall include the information described in subdivision (3) and (4) of subdivision (c) of Section 16336.4.

(B) In the case of a proposed change in payout percentage, the trustee gives written notice stating the new payout percentage that the trustee proposes to adopt, which notice shall comply with the requirements of Chapter 5 (commencing with Section 16500), and no beneficiary objects to the proposed action in a writing delivered to the trustee within the period prescribed by subdivision (d) of Section 16502.

(b) The trustee may make the reconversion or change in payout percentage at any time pursuant to court order provided that: (1) the court determines that reconversion or change in payout percentage will enable the trustee to better comply with the provisions of subdivision (b) of Section 16335, and (2) in the case of a change in payout percentage, the new payout percentage is at least 3 percent and no greater than 5 percent. The court may enter an order pursuant to this subdivision upon the petition of the trustee or any beneficiary.

SEC. 7. Section 16336.7 is added to the Probate Code, to read:

16336.7. (a) Sections 16336.4 to 16336.6, inclusive, shall not impose any duty on the trustee to convert or reconvert a trust or to consider a conversion or reconversion.

(b) Subdivision (b) of Section 16503 applies to all actions pursuant to Sections 16336.4 to 16336.6, inclusive, for which notice of proposed action is given in compliance with Chapter 5 (commencing with Section 16500), including notice to a beneficiary who is a minor and to the minor's guardian, if any.

SEC. 8. Section 16338 of the Probate Code is amended to read:

16338. In a proceeding with respect to a trustee's exercise or nonexercise of the power to make an adjustment under Section 16336, the sole remedy is to direct, deny, or revise an adjustment between principal and income. In a proceeding with respect to a trustee's exercise or nonexercise of a power conferred by Sections 16336.4 to 16336.6, inclusive, the sole remedy is to obtain an order directing the trustee to convert the trust to a unitrust, to reconvert from a unitrust, to change the distribution percentage, or to order any administrative procedures the court determines to be necessary or helpful for the proper functioning of the trust.